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NOTES AND MEMORANDA

THE EFFECTS OF INCREMENT TAXES UPON BUILDING OPERATIONS

A NUMBER of American cities have recently adopted special land taxes in the hope of gaining such social ends as increased building activity, lower rents and diminished speculation. Pittsburgh and Scranton, Pennsylvania, have reduced the assessed value of buildings from one hundred to ninety per cent, the first of a series of such reductions by which it is proposed to cut the tax on buildings to one-half the tax on land. Reading, Pennsylvania, has asked for power to make similar reductions. Pueblo, Colorado, has stricken fifty per cent of the building value from the assessment base and is committed to a plan eliminating this year all except one per cent of the value of buildings. Houston, Texas, after three years of experience with a plan under which buildings have been taxed at a figure at first one-third and later one-fourth of their value, is now forced by legal action to seek constitutional authority for the plan which before rested merely upon administrative audacity. In the city of New York the sentiment in favor of special land taxes has grown to such proportions as to make the question something of a political issue. One municipal commission has already reported in favor of a special tax on the "unearned increment."¹ Another commission, recently appointed, has been asked to give its recommendation on the question of reducing the tax on buildings and now has the matter under consideration.²

¹ The Commission on New Sources of City Revenue, appointed by Mayor Gaynor in 1911. See this Journal, vol xxvii, p 539 (May, 1913)

² The Committee on Taxation of the City of New York, appointed by Mayor Mitchel in 1914

Under these circumstances, a contribution to the theory of land taxation such as that made by Professor B. M. Anderson, Jr., of Harvard University, is welcome. In a recent article,¹ he has attacked the commonly accepted argument that " ' the unearned increment ' in land values is an incentive to building: that buildings which are expected to depreciate through obsolescence are often put on land that is rising in value in the expectation that the appreciation of the land will offset the depreciation in the building; and that consequently a tax which destroys the increment in land values would check building operations, instead of encouraging them as the single taxers contend." ² He flatly denies " that the amount of the increment in land value has any connection whatever with the amount of depreciation in building that is voluntarily suffered." ³ He concludes " that the increment . . . should have any influence on the decision to build is, on the face of it, impossible " and " that an extra tax on land for the purpose of encouraging building might be similarly barren of results." ⁴

Here is apparently destroyed at a single blow one of the best arguments against the single tax and at the same time one of the pet arguments urged in favor of it.

The article attracted immediate attention. A few weeks after publication it was quoted in the single tax session of the Conference of the National Tax Association to refute the claims of the single taxers that the exemption of improvements stimulates building.⁵ No one, however, seems to have

¹ " ' Unearned Increments,' Land Taxes, and the Building Trade," in this Journal vol xxviii, August, 1914, pp 811-814

² Loc cit., p 811.

³ Ibid , p. 812.

⁴ Ibid , p. 813

⁵ Professor Warren M. Persons. " I would like to call your attention to an article that appeared in the last number of the Quarterly Journal of Economics by Mr B M Anderson of Harvard, who takes up the point as to whether the single tax will bring about improvements, and in a word his position is that it will have little effect one way or the other, and his reason is this, that there will be no change in the basis of taxation whether the man builds or not. The question as to whether he should build is a financial one, and he will build if he can bring the earning power of the land into operation, and with that earning power, the earning power of the building. If the combination is such as to give him a return large enough to induce him to make his investment there, rather than elsewhere, he will make the investment there, and the proposition will be the same under the single tax as it is at present as the tax will be a constant factor whether the land is built upon or not. The economic needs of the community is the thing which will determine whether he will build or not " Proceedings of the Eighth Annual Conference, National Tax Association, p 457

made a serious attempt to criticize Professor Anderson's argument — a remarkable fact in view of its iconoclastic character. For it has been customary to hear from the lips of our leading economists the argument that the "unearned increment" is an incentive to early building and to the early settlement of agricultural land. It is stated in very definite form by Professor Alvin Johnson, in his "Case Against the Single Tax."¹ Moreover, in the city of New York, at least, real estate men testify that it has been the general policy in financing building operations "to assume that there will be year by year a steady increase in the value of the land which will more than offset any depreciation in the improvements."² An argument which runs counter to the statements of eminent scientists and the established policy of practical business men certainly deserves the most careful consideration. It is the purpose of this paper to criticize some aspects of Professor Anderson's argument and to suggest certain circumstances which seem to justify modifications of his general conclusions.

The case is argued by means of an arithmetical illustration, admirable in its clearness and compactness.

Assume a man who has a piece of land worth \$50,000 and free capital of \$30,000. Assume an annual increment to the land value of \$2000. The owner has two options: he may leave the land idle and invest his \$30,000 at, say, six per cent in industry, in which case his return is \$3800 per year (counting the increment); or, he may apply his \$30,000 to the land by building upon it, and so unlock the potentialities of the land, causing it to yield, say, four per cent, or \$2000, making his total yearly return \$5800 (again counting the increment). It is clear that in this latter case the owner gains if the depreciation of the building is anything short of \$2000 per year. But the \$2000 which offsets the depreciation is not the increment to the land value, but the extra \$2000 that comes from

¹ Atlantic Monthly, vol. cxin, pp 32-36 (January, 1914).

² Interview with Mr Alfred E Marling, of Horace S Ely and Company, member of the Advisory Council of Real Estate Interests and Chairman of the Mayor's Committee on Taxation in the city of New York New York Times, January 24, 1915 This policy, it may be stated, is at the present time in disrepute, because of the recent dulness in the real estate market and because of various "drastic demands" made upon real estate owners, including that of "excessive taxation" Cf interview with Mr Albert G. Milbank, *ibid* An attempt is being made to change the plan of financing building operations so as to provide for annual or semi-annual payments by the borrower on account of the principal of the indebtedness

putting the land to use. Varying the size of the increment leaves the situation unchanged. Assume an increment of \$12,000 per year: he can still tolerate only \$2000 per year depreciation. By using his first option, he would in that case have an annual gain of \$13,800; by using his second option, an annual gain of only \$15,800, still only \$2000 to spare. Assume no increment at all: he has still the same \$2000 margin for depreciation. The increment is wholly irrelevant. The significant factor is the possible addition to his income from releasing the earning power of the land.¹

Professor Anderson rests his case upon this example. His argument stands or falls by the validity of this illustration. The questions, therefore, to be considered are: Is the illustration typical? Does it fairly represent the situation? Are all the significant factors taken into consideration?

In the first place it will be observed that the annual return from the land is placed at \$2000 per year and kept at that figure year after year in spite of the fact that the capital value of the land is made to increase steadily. Is this condition typical? Is it usual for the annual return to remain constant while the capital value of the land increases? If increases or decreases due to changes in the general interest rate be disregarded, the only cause for an increased capital value is the prospect of an increased income. An increase in the selling value of a piece of land implies an improved income. The connection is direct and causal; and yet it is entirely ignored in the illustration. The example is therefore abnormal in this respect. A piece of land whose annual rentals, present or prospective, are not increasing but whose selling value is nevertheless mounting upward is an economic monstrosity.

This does not mean that Professor Anderson's statements are incorrect. Assuming the validity of his contention that "the significant factor is . . . the earning power of the land," the point should be recognized that this "earning power" will normally be an increasing sum under the condition of increasing capital value assumed in the illustration. To the individual, confronted with the option of building or not building, what Professor Anderson calls the increment, which will accrue whether he builds or not, may be "wholly

¹ Anderson, *loc cit*, pp 812-813.

irrelevant." The amount which he will forego in the annual land rent which he might collect, did he build, is, as Professor Anderson points out, the incentive to building and the margin for depreciation. What Professor Anderson does not point out is that this annual land rent — this incentive and margin — is expanding. This expanding earning power means an increasing capacity to carry taxes or to endure obsolescence. It is normally the basis and cause for increasing selling prices of land. It is responsible for the "unearned increment" in the sense in which the term is used in Professor Anderson's article.

Whether the statements made in the article are correct seems, indeed, to depend somewhat upon the definition of the word "increment." The ordinary dictionary meaning is "increase" or "augmentation." It has been very loosely used in economic discussions to indicate increases of various sorts. In the case of land it has commonly been used to describe augmentations of the capital or selling value. Examples are not lacking, however, of the use of the term to describe augmentations of the annual value or yield of the land.¹ The term should, of course, be used to describe only one thing. The question of terminology need not be further discussed here, but to avoid confusion increases in capital value will hereafter be described as "capital increments" and increases in annual rentals as "yield increments." Professor Anderson seems to use the term to describe such "capital increments" as can be realized without improving the land or subjecting the individual to any expense. If "yield increments" are true increments, the statements as to the effects of increment taxes must be modified.

The first criticism, then, is that the arithmetical example is not typical in that it does not recognize an increasing "yield increment" as a basis for the "capital increment."

In the second place it is believed that the example ignores a practical factor of considerable significance. It is assumed that the landowner may, without expense, hold his land out of

¹ Mr C B Fillebrown uses it in both senses in the same pamphlet, *A 1916 Single Tax Catechism*, pp 17, 18

use and realize upon his "capital increment." It is assumed that the only burden that he is called upon to bear is the sacrifice of the annual income from the land which he might receive if he constructed a building. But under actual conditions his burden is not merely this negative sacrifice: it includes a positive expenditure, for his ordinary annual taxes must be paid if he is not to be deprived of his land and of all prospects for future incomes, large or small. In Professor Anderson's illustration, the owner has \$30,000 of free capital, which, invested in industry, yields him \$1800 a year. It is clear that he could pay indefinitely any tax which did not absorb more than this income. But any sum paid for taxes will reduce the sum realized under the first option where the capital is put into industry and the land allowed to lie idle.

The individual of the illustration, however, with his \$30,000 free capital is in a condition of opulence compared with that of many owners of vacant land. Often the free capital is entirely absent, the individuals borrowing the funds when the land is "ripe" for building. In such cases, from what source will the annual taxes come? It may be said that if a man's land has a capital value he can borrow upon its security to pay taxes and that such a course will pay under these circumstances. But in many places unimproved land is not acceptable security for loans. Money can often be secured to improve a piece of property when it cannot be obtained to "carry" a piece of vacant land. This is the case in western Canada. The prohibition in force until recently against the use of land as security for national bank loans may be explained in part on the ground of our distrust of such security. In the city of New York the savings institutions, life insurance companies and trust companies will not make loans upon the security of unimproved real estate, and if a landowner desires an accommodation he must find some private individual who is willing to join with him as a preferred partner in his speculation. He must pay a higher interest rate and give a wider margin of security than if the land were improved.¹

¹ The writer is indebted to Mr. Walter Landner, of the Title Guarantee and Trust Company, for this information.

Under these conditions it will be seen that an individual owning vacant land and confronted with the problem of whether he shall build or not must always consider the cost of carrying the land until he can realize on the "capital increment." He must compare the total taxes plus interest with the "capital increment" to be realized. Where loans are not made upon vacant land and where the owner is without cash resources — a very common situation at present in western Canada — to build may be the only way to meet tax bills. He can borrow money to build and his property will then, perhaps, bring in enough money to pay interest and taxes. In this way his title to his "capital increment" may not be lost to him. Under such circumstances it may be profitable for a man to build even when his rentals are insufficient to pay the entire interest and replacement charges on the building, not to speak of a return upon the land. If he can secure enough from his rentals to pay the current bills of interest and taxes he will build, provided that the "capital increment" finally to be realized promises to be great enough to care for the other expenses and leave something beside.¹ In other words there are circumstances where part of the "capital increment" is sacrificed to save the remainder and the process involves building. If the tax so impairs the "capital increment" that it is not worth saving, the means of salvation will not be adopted — that is, fewer buildings will be built.

It is admitted, of course, that if funds may be borrowed freely upon the security of unimproved land, the above argument does not hold. There is, however, always a difference of opinion between the money lender and the landowner as to the value of the land or, in other words, as to the certainty and amount of the future yields from the land. If this were not true the money lender would usually become landowner and take his return in rentals and increments rather than in interest and repayments.

It may be that there is much more than merely this involved in the struggle to preserve titles to increments. Not

¹ In some places in western Canada, South Vancouver, for example, buildings are exempt from taxation and in addition a special tax is levied against unoccupied land. Here one can actually reduce his tax burden by building

only are the city builders affected by the speculative opportunities — not only do they build in order to be able to meet current charges hoping to reimburse themselves for present losses from increased land rentals or selling values later — but farmers also are similarly affected. It has many times been pointed out that part of the middle-western farmer's return has come from the increased value of his farm. The point has not been emphasized, however, that to preserve his title to that increased value, it has been necessary for him to sacrifice some of it beforehand. To benefit by the increment it was necessary for the settler to do more than to sit with folded hands. He, like the city landowner, is subject to an annual land tax. In certain cases residence upon the land is also necessary to the establishment of the title and this residence often involves a real cost. To meet these charges he has slight resources. The settler is proverbially "land-poor." He has faith in the future "capital increment." The money lender has less faith. The settler must somehow meet the charges and will cultivate the soil when the returns do not justify it — he will "skin" the soil, if need be — in order to meet them. He, too, sacrifices part of his future to save the remainder. Thus, if our buildings are constructed by speculators hoping to preserve increments for future appropriation, our farms are first carved out and cultivated by speculators spurred on by the same motive. The significance of this in connection with the struggles on the frontier for land banks, "cheap money," and internal improvements is obvious.

Professor Anderson's statement, then, that the "earning power of the land" is the "significant factor" and that the "capital increment" is "wholly irrelevant" assumes that the "capital increment" will accrue to the credit of the individual whether he improves his land or not. The second criticism resolves itself into a charge that this assumption ignores a very important practical consideration. There are expenses necessarily involved in holding land over a period of years which are often heavy and which, because of the discrimination which is commonly made against land as security for loans, are peculiarly difficult to meet. By improving the

land a revenue may be secured which will aid to keep clear the title to the "capital increment." Thus, where a building must be constructed because of the presence of practical circumstances connected with the loan market, the case is materially changed. The size of the "capital increment" then enters as a factor which must be compared with the expenses of preserving title to it. Any part will be sacrificed to retain the remainder. The entire destruction of the increment by a tax would, under these circumstances, cause a diminution in building. Any reduction in the size of the increment would probably throw some building projects over the margin.

It will be agreed, therefore, that a restatement of conclusions is necessary in order to take account of important practical factors in the situation. Is the increment a lure which has hastened the settlement of our prairies and the building of our cities? In the light of the foregoing discussion it appears that it is the attraction of the increment which leads to the efforts to establish claims to land. But does it explain why men farm and build, as they do, before they can secure a proper return on their investment? The answer must be that it is not the "capital increment" which is directly responsible. It is rather the necessity of preserving the title to that increment. The increment seems to be like the "greased pig" at the county fair — often easier to catch than to hold. It is to pay taxes and to keep body and soul together that the settler strips his land of its fertility and the builder allows his structure to depreciate without making proper immediate provision for replacement. In so far as the lure of the "capital" increment is responsible for these sacrifices, it should be given credit for encouraging early building and settlement. To destroy the increment will eliminate the necessity of making sacrifices in order to secure it. The effect undoubtedly will be that building and settlement will take place less soon.

The facts, then, are as the business man states but not exactly for the reason he states. Professor Anderson has pointed out that the reason given is not adequate, but he

offers, on his part, no explanation of the facts. It has been an error to ascribe building activity directly to the increment. It is not the increment which supplies the direct, compelling force. The real cause of early building is the pressure of charges of various sorts, the most important of which are annual taxes. Professor Anderson's article calls attention to this inaccuracy in a very conclusive fashion. But, nevertheless, were it not for the increment, operating in this indirect fashion as the reward which justifies the present sacrifice, the increased building would not take place. The conclusion must be that, under the conditions actually present in many places, the impairment of the "capital" increment by taxation would operate to discourage building operations.

Within limits ¹ anything which increases the annual burden or increases the final reward of the man who is attempting to carry land in order to realize on the "capital" increment would, then, from this point of view, encourage building. A tax on the "yield increment" would, at the same time, increase the annual burden and *decrease* the final reward, for, presumably, the tax would continue after the land has changed hands and would result in the impairment of the "capital increment" for which the individual is striving. The effect upon building operations will depend, therefore, upon the relative strength of these opposing forces.

The statements made in regard to the effects of increment taxes have assumed that the increment is expected and counted upon. This suggests another distinction of possible usefulness. Increases in land values are always imperfectly discounted. If they were perfectly discounted, all would be paid for in the market price of land. Some are paid for in this fashion; some are not. Certainly the rate of increase and the rate of discount are independent of each other. Some increments are, then, expected, discounted and paid for; others are unexpected, undiscounted and unpaid for.² The distinction between "expected" and "unexpected"

¹ The annual burden could be made too high to be borne, of course

² Moreover the mere fact that an individual expects an increment, does not, of course, "earn" the increment. The increment may be entirely "unearned" and yet be fully discounted.

increments is of some importance, because many individuals will not object to a plan which takes by taxation only that which has not been expected and paid for, but would object to another form of the increment tax. Obviously the only increment which is of any importance in influencing a decision to build is the increment which is expected and counted upon. A tax could take all this unexpected increment without affecting any decisions to build. If a line could be drawn between discounted and undiscounted increments, a tax could be imposed upon the undiscounted increments without the risk of unfavorable results upon building activity and without incurring the charge of confiscation. The wisdom of the provision of the English increment law, which provides for the exemption from the tax of a ten per cent increase, here becomes apparent. Perhaps such a provision comes as near as possible to a practicable distinction between "discounted" and "undiscounted" increments.

The degree of certainty and the possibility of unexpectedly large returns are the factors responsible for the relatively small return usually received from investments in land. Destroy the possibility of an increased return, through either "capital" or "income" increments, and the rate of return upon land must increase to a level at least as high as that upon other forms of investment.

The objection raised by Professor Anderson, that, because leased land competes with "owned" land in the same market as sites for buildings, the increment cannot be an incentive to building, seems to offer no great difficulties, theoretically. The owner of a piece of land which is rising in value and which is the occasion of expense difficult to meet may find it to his advantage to lease his land to a builder for any sum he can get. No matter how small the return, it will assist so much in aiding the individual to pay his taxes and preserve his title to his land and his future "capital" increment.

A discussion of the effects of other types of land taxes upon building operations cannot be included within the limits of this paper. The first step toward increased land taxation in most of the communities of the United States seems to be

to raise the assessment of vacant land to full value as compared with other real estate. What will be the effects upon building of this step and of the policy of exempting improvements, which is already being adopted, will depend upon a variety of conditions. In most cases, the writer believes, the changes will not be "barren of results," but will stimulate building to some degree.

In this paper, also, the observations "cover only a small part of the points in controversy." It is believed, however, that the main point is an important one. Certainly a debt of gratitude is due to Professor Anderson for demonstrating so conclusively the inadequacy of the currently accepted explanation of the influence of increments upon building and voluntary obsolescence. It is the explanation, however, which has been at fault. The influence is still present. But it is not exercised directly, as has been claimed, but indirectly and in a fashion not recognized. The increment is a reward whose attainment, under ordinary conditions, demands a sacrifice. The form which this sacrifice takes is in cities early building and voluntary obsolescence, and in rural districts early settlement and impoverishment of land.

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TWO RATE DECISIONS OF IMPORTANCE

Two rate decisions have recently been made, both noteworthy because of the importance of the questions at issue. One was rendered by the Massachusetts Public Service Commission, and considers the obligation of the state towards securities which it has approved; the other is by the New Jersey Court of Errors and Appeals, and deals with the problem of franchise values.

The Massachusetts decision considers whether and how far the approval of securities by a public utilities commission